

# INSIDE INFORMATION

The newsletter for serious financial advisors. ([www.bobveres.com](http://www.bobveres.com))

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## THE 'WISDOM AND VALUES' ESTATE

*A new life planning process addresses the most complicated area of financial planning.*

**C**am Thornton, of Cameron Thornton Associates in Burbank, CA, has been training for advanced estate planning for the past 26 years. He was part of the late Scott Fithian's Legacy program back in the late 1980s and early 1990s, and learned to do complex planned giving work through Renaissance, Inc. After attending the estate planning sessions at countless conferences, Thornton created his own unique legacy planning process by pulling together the best ideas from presenters, estate attorneys and his peers around the profession.

This may explain why, when Thornton heard about a new organization that provided advanced estate planning training, he was initially skeptical. "I asked myself, what could the Heritage Institute teach me that was different from what I learned from the others?" he says. "So I spent six months doing my due diligence on them, trying to understand their principles and see if there was anything they had to offer me."

In April of last year, Thornton began taking courses at Heritage's Portland, OR offices, and this year he has revamped the way he works with clients. "The program I use now is repeatable for everybody; it doesn't make any difference if you are dealing with somebody who has \$100,000 or \$100 billion in assets," he says. "We are able to help people get really clear on the things that are of greatest importance to them. It's the best thing I've done for my practice."

The Heritage Institute (<http://www.theheritageinstitute.com>) is a relatively new organization

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## EARLY WARNING

- The SEC released a scary-looking document on August 7, entitled "Commission Guidance on the Use of Company Web Sites," which talked about "the use of company web sites under the Exchange Act and the antifraud provisions of the federal securities laws," and also "company use of technology generally in providing information to investors."

Relax. The release stirred up a response among bloggers, but the

most well-informed were members of the IT and PR departments of large public companies, who recognized that they were the sole target of the release. The 47-page release focuses on whether public companies can release material information via their web sites and blogs, and do away with press releases. The SEC worried that material information would get buried on a seldom-visited web site, rather than released to the public. View the 47-page release here: <http://www.sec.gov/rules/final/33-8230.htm>.

# Deep Diversification, Deep Value

*In investing, sometimes the best offense is a good defense.*

**M**ike Martin, of Financial Advantage Corp. in Columbia, MD has been described as a “perma-bear.” I don’t agree with the characterization, but I think the label stuck to him after he publicly expressed his suspicions of market valuations in the heady days of the late 1990s and occasionally since then, and also, perhaps, because he’s one of the few advisors who has incorporated some double inverse funds into his client portfolios.

A more accurate description is that he’s one of the few advisors who has been consistently, unwaveringly looking at the market from a historical standpoint, and one of the first things he notices is that today’s PE levels are still, despite all the angst, turmoil and minus signs, hovering above our long-term norms.

“While we’re in the upper 20% of historic valuation ranges, the risk of owning these inverses isn’t that great, and the opportunity seems terrific,” Martin explains. “If I perceive that we’ve moved into the middle 60% of historic valuation ranges, I wouldn’t have these. And if we were in the bottom 20% of being really cheap

compared to historic PEs, I might go the other way and buy 2X long funds.” Does that sound like a rigid bearish outlook to you?

Today, most of Martin’s client portfolios are invested about 45% in stable assets, which consists of money market funds, Treasuries and short-to-intermediate bond funds like PIMCO low duration

of the portfolio work that much harder.”

This starts you on the train of logic that led to the inverse return funds. Martin believes that the investment universe can be divided into four fundamental types of assets—cash equivalents, which he already has in abundance, plus real assets, ownership of businesses (stocks) and loans, which he defines as bonds with risk. His goal with the hard-working part of the portfolio is to buy undervalued longer bonds, stocks and real estate, which, in today’s market, represents a challenge. “None of those things look as though they have high expected returns

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and FPA New Income. This chunk of the assets will return 2-3% a year currently, which is a problem for Martin, since his overall goal is 4% above inflation—an estimated 7% nominal if you expect 3% inflation. TIPS make up another 5% of assets. “Getting 3% on 45% of my assets is not helpful,” Martin admits. “Since almost half of my portfolio loses buying power by intention, I have to make the opportunistic part

to me,” says Martin. “In fact, I think we have a lot of correction possibilities going on here. That led me to say, what can we do that is totally, dependably opposite? That’s how we got to the inverse funds, and also to gold.”

Gold? “I have no idea how to answer you if you ask me what gold is worth,” Martin admits. “But I do know that it hasn’t lost its historic image of being a currency equivalent, and of all the

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## Deep Diversification, Deep Value

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things that I have some conviction about, the strongest is that we--society or modern civilization--cannot avoid corrupting our paper currency. We've made so many promises to huge beneficiaries of government largesse--Medicare, Medicaid, the federal and current account deficits, consumer debt, state debt--the only thing they can do to get out of this hole," he says, "is reduce the value of those nominal obligations by reducing the value of the currency."

Martin also takes some comfort in the fact that the emerging economies of China, India and the Middle East still value gold as a store of value, which means demand will tend to be higher than it would be if gold were purely valued as an industrial commodity. However, he has been trimming positions from the original 5% as the metal has risen in value. "We started when gold was at \$480 two years ago," he says. "It ran up to \$700, then pulled back to \$580 or so and we raised our position. When it went over \$1,000, we trimmed our position, and rebalanced at \$870."

The inverse funds make up another 5% of the portfolio, but since they move twice as far as the market, this effectively becomes a 10% exposure. The opportunistic part of the portfolio also contains a REIT whose ticker symbol is LSE--a combination of commercial properties and a side business making loans and mortgages to properties with investment grade

tenants who have taken out long-term leases. In the same category (real assets), Martin has clients invested in a gas infrastructure utility called Spectra Energy, two Canadian royalty trusts, Apache Oil, and a business development company called Allied Capital. Long bond exposure comes from Loomis Sayles Bond Fund and some long-duration TIPs.

Another segment of the portfolio is what Martin describes as macro-driven. "These investments are more influenced by top-down forces than specifically company-driven activities," he explains. "That includes emerging markets, but our only emerging market entry, so far, is Tata Motors, an Indian automotive company.

The next piece of the opportunistic puzzle is deep value investments. Martin buys exposure here through familiar managers like Longleaf Partners, First Eagle Global Value, and Third Avenue Value.

Finally, Martin looks for special situations--a small handful of individual companies that seem to define the deep value niche. For example, consider Duke Energy, which is currently paying a 6% dividend yield. "When you see that," says Martin, "the market is saying to you that this dividend is going to get cut. For a couple of different reasons, I had a pretty high conviction that it would not be cut. It turned out that was a good instinct."

Another special situation

is Dresser Rand Corp., which Martin describes as the dominant manufacturer of rotating equipment--compressors and turbines for the energy infrastructure field. "I know about them because I followed them when I worked as an analyst on Wall Street," he says. "I know their business and their cycles, and we bought it very early in the cycle." The stock grew to 3% of the typical Financial Advantage client portfolio, at which point Martin trimmed it back to 1%. "Either it will go higher and we'll get rid of it," he says, "or it will go lower and we'll start building a position again."

The astute reader will have noticed what is NOT in these portfolios: a core holding of the S&P 500, surrounded by funds that fit into the Morningstar style boxes. "I'm concerned that owning large cap, small cap, growth and value doesn't really diversify you," says Martin. "If I stayed with the traditional definition of diversification, my clients may not have a portfolio as stable as I want it to be, because these categories will all be moving at the same time.

"In fact," he adds, "that's what we've seen in the last year or two. In our portfolios, every quarter we see a huge variety of returns quarterly, and that gives me great comfort."

For an alleged permabear, the equity parts of Martin's portfolios seem more opportunistic than defensive. In fact, the more

uncorrelated his investment positions are, the more volatile he hopes their performance will be. The most obvious examples are the 2X inverse funds, but one can also find plenty of volatility in gold and individual stocks, and deep value funds have been known to go into periodic funks. Martin believes that by rebalancing whenever an asset class gets 20% or more from its target, he can turn that volatility into another boost to the portfolio--by consistently, systematically selling high, buying low and paying less per share for just about everything.

One example is the Canadian royalty trusts, bought for \$11 a share. Martin doubled his client positions when it fell to \$8.50. It climbed back to \$12 soon afterwards. Others have followed this same general pattern. "Apache doubled in the course of 12 months," he says, "and we rebalanced back to our allocation when the stock was 118 and again at 142. When it fell back down to 126, we bought it for our clients who were underweight. All of that happened in three months," he says. "With gold, something like that might happen once a year, but when it does, we get the benefits of rebalancing there, too."

In Martin's client conversations, the topic isn't how scary or terrible equities are, but more often are led by a client noticing that this or that individual asset is down some horrible percentage like 15% year-to-date. "I say it so often that I can say it in

my sleep; I tell clients, you really don't want everything in your portfolio going up at the same time," says Martin. "And they look at me like I'm playing with them. They say, I don't??? Then I say, that means they will probably all go down at the same time too. I would rather squeak out steady returns than have it bounce around in tandem."

There is no easy way to sum up this investment philosophy, because there are so many moving parts. One goal is to embrace volatility on the individual asset level, while controlling it on the portfolio level. Another is to seek out the kind of deep diversification that seems not to be available in traditional asset classes. In addition, Martin is watching historical valuations and avoiding those assets which are still lingering in the upper end of their historical ranges.

And, finally, Martin is watching a bigger picture than most advisors I talk to. "I think, sometimes, you can hear something rumbling below our portfolios," he says. "Look at the big macro factors: interest rates falling from 14% to 2%, the aging of the industrial world's populations, globalization and all the forces that are being unleashed by that, the topping out of a generation-long leveraging up the economy, which will have to be reversed in a very long and painful process. 25 years ago," Martin continues, "total nonfinancial debt in the U.S. was about 150%

of GDP. Now it's 350%, when you count personal, government and corporate. A lot of things that were once tailwinds to the market have become headwinds."

Now, finally, Martin is starting to sound like a bear--but, perhaps, just a situational one, somebody who looked with approval at the market conditions of 1982, and sees a very different world in 2008. "I think the environment is going to be much harder from an economic point of view than it has been in the last 25 years," he says. "When you switch over from looking at the fundamentals to the valuation of securities, you see that for 20 years, from 1980 to 2000, you could make a lot of money in stocks and bonds. That was the environment in which fixed allocations became very popular. It worked fine.

"I think you have to change your mindset," he adds. "You don't have the environment you had. You don't have the same economic fundamentals, and you don't have the starting point you had in the early 1980s.

"I am a big believer in capital markets and economic freedom," Martin continues. "I think you just have to find where the opportunity is, and not pretend that the only way to be an optimistic American is to have 60% of your money long domestic stocks. You can be a lot more creative to serve your clients well."

Should we call him "perma-creative?" ■